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Bold ideas for solving America's financial mess

Illustration by Jac Depczyk



EVERY financial crisis involves a tug of war between the tacticians and the strategists. The tacticians dash from skirmish to skirmish trying to control a crisis, deciding in each case whether taxpayers should bail out a distressed bank, firm or country. The strategists call for a more comprehensive approach to resolving the mess—often involving new government bodies to recapitalise banks or take over troubled assets.

The present crisis in America conforms to this pattern. So far, the government's response has been ad hoc and focused on crisis containment. The tacticians at the Federal Reserve and the Treasury have put plenty of taxpayers' money on the line—whether through the huge expansion in the central bank's liquidity facilities, the loan to Bear Stearns in March, or the government takeover of Fannie Mae and Freddie Mac, the mortgage giants, and, now, of AIG, a huge insurer. But they have focused on staving off catastrophe one bail-out at a time.

Now the strategists are pushing back. From across the political spectrum people are arguing that it is time for America to shift to a more systematic approach. In the past week Barney Frank, the

leading Democrat on financial matters in the House of Representatives, Paul Volcker, a former chairman of the Fed, as well as writers of the editorial pages of the *Wall Street Journal*, have suggested that Congress may need to create a new agency to deal with the mess. All have pointed to the Resolution Trust Corporation (RTC), a government body set up in 1989 to deal with the fallout of the savings and loan (S&L) bankruptcies.

Americans focus on the RTC because it is the country's most recent example of a comprehensive government plan to deal with a financial crisis. Between 1980 and 1994 almost 1,300 specialised mortgage lenders, known as thrifts, failed. Their combined assets amounted to more than \$600 billion. By 1986 these failures had bankrupted the Federal Savings and Loan Insurance Corporation, the federal insurer for the thrift industry. At first the government tried to muddle through by trying to recapitalise the insurer. But the S&L mess escalated. In 1989 Congress created the RTC, an entirely new organisation, to dispose of the failed thrifts' assets in a way that minimised downward pressure on financial and property markets.

The RTC is not a perfect parallel for today's needs. It was set up—years after the S&L crisis began—to deal with the aftermath of widespread bank failures. Those who advocate comprehensive action today want to minimise the mess, not just clean up afterwards. Their proposals vary, but many who cite the RTC envisage an institution that buys troubled mortgage-backed securities (not only from failing institutions), putting a floor under their price. Some propose that the putative new agency should manage and write down the underlying mortgages, in effect combining the functions of the RTC with a Depression-era institution, called the Home Owners' Loan Corporation, which bought and restructured defaulting mortgages. Details are in short supply, but intellectual momentum is building for a broader solution.

Not a moment too soon, suggest the results of a new study by Luc Laeven and Fabian Valencia, two IMF economists.* They examined all systemically important banking crises between 1970 and 2007, creating a database on how much financial crises cost and how they are resolved. The evidence is clear. Tactical crisis containment is expensive and frequently inadequate. In most financial meltdowns a comprehensive solution was required, and the sooner it was provided the better.

The study looks at 42 crises in all, spanning 37 countries. Like America today, most governments began with ad hoc crisis management. In 74% of cases, for instance, governments pumped emergency loans into failing banks or guaranteed their liabilities. An equally common tactic has been regulatory forbearance. Governments allowed banks to hold less capital than was normally required or softened their rules in other ways. These tactical responses, however, often did not work and ended up increasing the overall bill from a crisis. "All too often", the economists conclude, "central banks privilege stability over cost in the heat of the containment phase."

No such thing as a free crunch

Sooner or later most governments realise the need for a comprehensive solution to the crisis, involving public funds. This can take different forms, from bank recapitalisation to forgiveness of all the underlying debts. In three-quarters of the cases, governments shored up bank capital by, for instance, injecting preferred stock. About 60% of the time, governments set up institutions to manage distressed assets.

The evidence from these attempts is sobering for proponents of an RTC II. Some institutions worked well. In the early 1990s, for instance, Sweden successfully set up an asset-management

company to take over and sell the bad loans from its biggest banks. But, in general, the paper argues, such government-owned asset-management firms are ineffective—often because politicians try to push them around.

On average, the study finds that government attempts to stanch systemic banking crises over the past three decades have cost 16% of GDP. That average hides enormous variation, much of which depends on how crises were handled. America's mess, even if it has already led to the demise of famous Wall Street firms, is far from finished. That is why the international lessons are worth taking seriously. Resolving a financial mess is cheaper, quicker and less painful if governments take a rounded approach. For the moment, the bail-out tacticians are in overdrive. But the strategists' moment is approaching.

* "Systemic Banking Crises: a new database". IMF Working Paper. September 2008.

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